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before the

Agriculture Subcommittee for
General Farm Commodities and Risk Management
United States House of Representatives
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Introduction

Mr. Chairman and members of the committee, thank you for the opportunity to come before you today to discuss posted county prices (PCPs). Joining me today is Mike Yost, Farm Service Agency, Associate Administrator for Programs and Bert Farrish, Deputy Administrator for Commodity Operations.

This committee has asked the Department of Agriculture to meet two objectives in this hearing: (1) to assess the technical procedures of USDA's establishment of PCPs; and (2) to explain the Department's plan to continue to improve accuracy in this system.

My testimony today will answer four questions. First, what is the legislative history of PCPs that brings us to where we are today? Second, what are the formulas and the technical procedures for calculating PCPs? Third, what are the underlying issues of PCPs that have some producers frustrated with this system? And fourth, what are some of the components of the plan to improve the operation of the PCP system?

PCPs affect the business of growing and marketing 17 different commodities. USDA sets more than 88,000 PCPs each day, five days a week. Those prices cover corn, barley, oats, soybeans, grain sorghum, canola, crambe, rapeseed, flaxseed, sesame seed, sunflower seed, safflower, mustard seed, small chickpeas, lentils, dry peas and five different classes of wheat. The PCP system is a very hands-on process. Farm Service Agency (FSA) employees in Kansas City and here in Washington analyze prices from the Data Transmission Network (DTN), the Agricultural Marketing Service (AMS) and commodity exchange activity daily. In addition, FSA contacts market representatives across the nation about 500 times each day. The information we gather today is the basis for PCPs tomorrow.

I. Legislative History

The marketing assistance loan program was amended by Congress in the Farm Security and Rural Investment Act of 2002 (2002 Act), but has origins dating back to 1983.

The origin of the PCP system began with the payment-in-kind (PIK) program in 1983. At the time, USDA needed a way to value corn inventory controlled by the Commodity Credit Corporation (CCC).

The Food Security Act of 1985 (1985 Act) was the first "legislative" step toward creating PCPs. The 1985 Act amended the Agricultural Act of 1949 (1949 Act) requiring the Secretary to offer marketing assistance loans and loan deficiency payments (LDPs) beginning with the 1985-1990 crops of rice and the 1986-1990 crops of upland cotton and feed grains. Marketing assistance loans and LDPs were discretionary for the 1986-1990 crops of wheat, feed grains and sorghum. Furthermore, it provided for the issuance of commodity certificates for wheat, feed grains, upland cotton and rice (program crops).

Congress further amended the 1949 Act with the Food, Agriculture, Conservation and Trade Act of 1990 which required the Secretary to extend marketing assistance loans and LDPs for the 1991-1995 crops of minor oilseeds, upland cotton and rice. The 1990 Act required the Secretary to offer marketing assistance loans and LDPs through the 1995 crops for covered commodities.

The Federal Agriculture Improvement and Reform Act of 1996 (1996 Act) mandated marketing assistance loans and LDPs for the 1996-2002 crop years of rice, upland cotton, wheat, feed grains, soybeans, and oilseeds.

Section 1204 of the 2002 Act continued the authorization of marketing assistance loans and LDPs and permits a producer to repay a marketing assistance loan for a loan commodity (other than upland cotton, rice and extra long staple cotton) at a rate that is the lesser of either:

- The loan rate established for the commodity, plus interest;

or,

- A rate the Secretary determines will…
  - minimize potential loan forfeitures;
  - minimize the accumulation of stocks by the government;
  - minimize the government's cost for storing the commodity;
  - allow the commodity to be marketed freely and competitively both domestically and internationally; and
  - minimize discrepancies in marketing loan benefits across state boundaries and county boundaries.

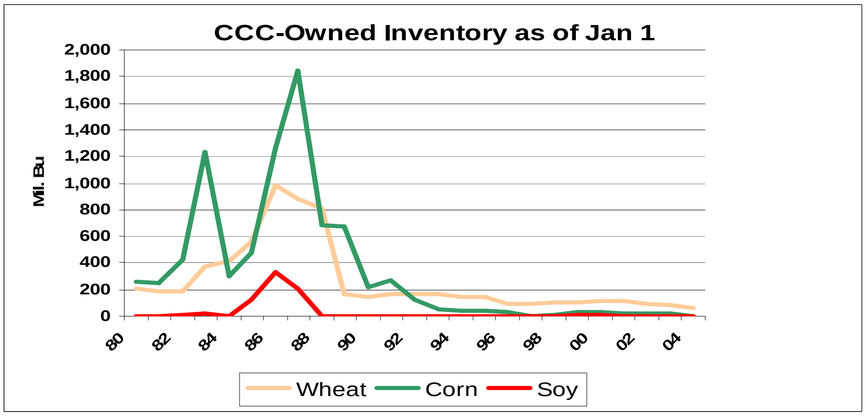
Peanuts are now covered by marketing assistance loans and LDPs. LDPs are available as well for cotton and rice as part of the loan system but with different LDP language.

Determining a rate that simultaneously meets these statutory objectives will not guarantee that PCPs will generate an LDP plus the local cash price that equals county loan rates. There is a significant misconception that takes place pertaining to PCPs. Producers often assume that their LDP plus the local cash market price must equal their county loan rate. However, the 2002 Act does not guarantee this. The LDP aspect of the loan program is designed to avoid forfeitures. Utilizing the loan provision is the only way for the producer to guarantee receipt of the loan rate for the applicable crop. The loan is the benefit, not the LDP.

Historically, Congress has asked the Department of Agriculture to minimize forfeitures. It is for good cause. Forfeited commodities are a burden on taxpayers and a challenge for the Department to manage. The current system does, in fact, minimize forfeitures. *Illustrations 1* and *2* on the following page demonstrate a dramatic drop in commodity ownership during the late 1980s and, in recent years under marketing assistance loans, the quantity of wheat, soybeans and feed grains forfeited to the CCC has remained below one percent of production

Illustration 1

CCC-Owned Inventory as of January 1: 1980 – 2004



This table illustrates the change in CCC commodity ownership (1980-2004) by crop, year, and amount.

Illustration 2

	Wheat	Corn	Soybeans
	(mil. Bu.)	(mil. Bu.)	(mil. Bu.)
1980	203	254	0.5
'81	191	248	0.5
'82	185	429	14
'83	376	1230	23
'84	419	296	3
'85	557	477	124
'86	987	1265	333
'87	883	1843	212
'88	805	679	0.5
'89	161	676	1
1990	145	214	0
'91	161	265	0.5
'92	165	125	0
'93	168	54	0.5
'94	144	44	0.5
'95	141	42	0.5
'96	96	30	0
'97	93	2	0
'98	107	15	3
'99	104	26	7
2000	109	36	10
'01	118	24	4
'02	93	18	3
'03	78	16	0.5
'04	62	1	0

Illustration 3 depicts the successful management of forfeited grains from 1999 to 2004.

Illustration 3

Crop Loan Forfeitures 1999-2004

Commodity	Crop Year	Estimated Production (NASS)	Quantity Forfeited to CCC	Percent of Production Forfeited
Corn (bu.) *				
	1999	9,430,612,000	31,696,419	0.3361%
	2000	9,915,051,000	26,596,167	0.2682%
	2001	9,502,580,000	17,027	0.0002%
	2002	8,966,787,000	1,892,953	0.0211%
	2003	10,089,222,000	1,037,721	0.0103%
	2004	11,807,217,000	16,741,632	0.1418%
Soybeans (bu.)				
	1999	2,653,758,000	11,479,156	0.4326%
	2000	2,757,810,000	5,704,769	0.2069%
	2001	2,890,682,000	54,506	0.0019%
	2002	2,756,147,000	205,169	0.0074%
	2003	2,453,665,000	122,168	0.0050%
	2004	3,123,686,000	413,485	0.0132%
Wheat (bu.)				
	1999	2,295,560,000	29,967,120	1.3054%
	2000	2,228,160,000	12,749,123	0.5722%
	2001	1,947,453,000	442,849	0.0227%
	2002	1,605,878,000	1,507,263	0.0939%
	2003	2,344,760,000	2,480,904	0.1058%
	2004	2,158,245,000	7,007,622	0.3247%
Barley (bu.)				
	1999	271,996,000	1,341,092	0.4931%
	2000	317,804,000	670,937	0.2111%
	2001	248,329,000	0	0.0000%
	2002	226,906,000	0	0.0000%
	2003	278,283,000	239,748	0.0862%
	2004	279,743,000	198,713	0.0710%
Sorghum (cwt.) *				
	1999	595,166,000	446,079	0.0750%
	2000	470,526,000	200,165	0.0425%
	2001	514,040,000	0	0.0000%
	2002	360,713,000	95,134	0.0264%
	2003	411,237,000	33,295	0.0081%
	2004	454,899,000	158,287	0.0348%

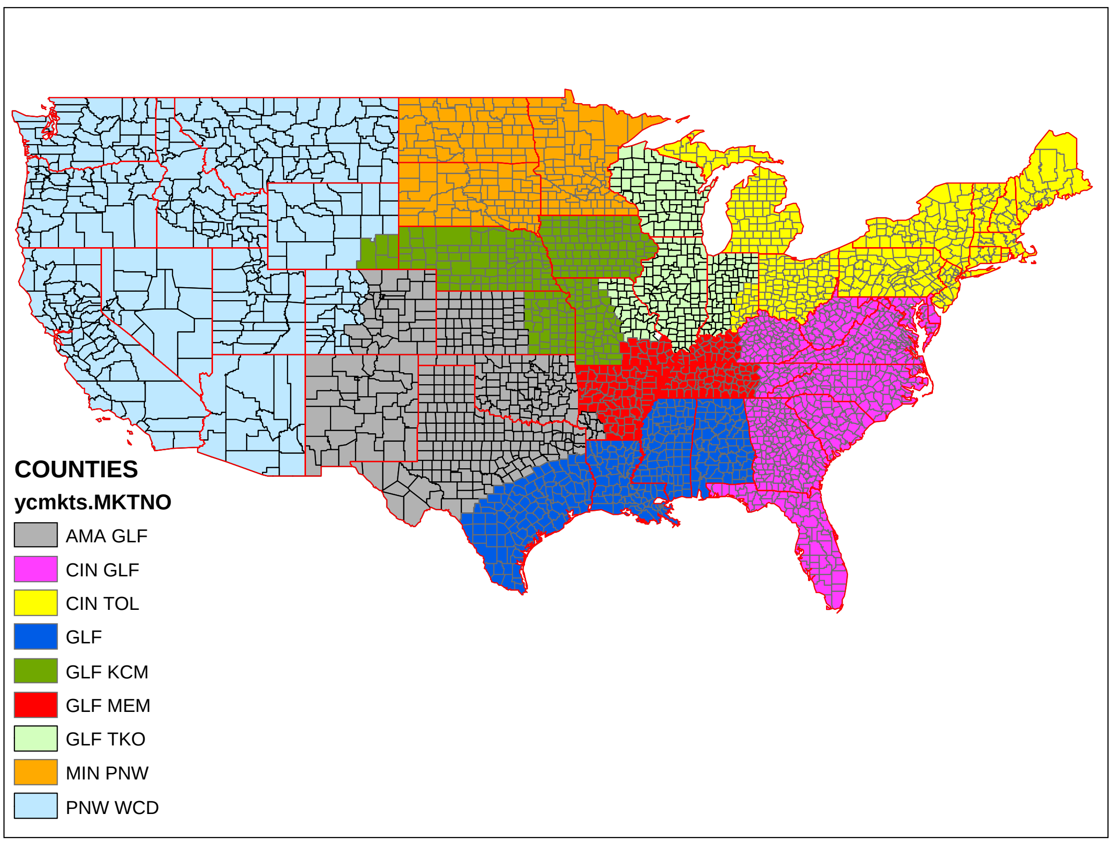
* Excludes Silage.

II. <u>Technical Procedures for Calculating PCPs</u>

Overview – The PCP is a proxy for the cash value of a commodity. It is determined by taking terminal market prices then adjusting for a value reflecting historical price relationships between local and terminal market prices (county differential) and then adding or subtracting a value to minimize differences across state and county boundaries and reflect localized current year market anomalies (terminal adjustment).

The **terminal price** (TP) is the average cash offerings for *a* commodity in *a specified* terminal market on *a particular* day. USDA employees analyze DTN, AMS and commodity exchange activity daily and acquire data on cash offers for *that* commodity through personal daily contacts with commodity buyers in *that* market. For corn, there are 10 terminal markets used by USDA in the United States. *Illustration 4* depicts the corn terminal market combinations. Counties are assigned at least one terminal for each commodity (in most cases two terminals are assigned).

Illustration 4
Corn Terminal Market Combinations



The **county differential** (CD) is an assigned value based on historical price relationships between local county market prices and assigned terminal prices for *that* commodity. The assigned county differential reflects price differences between local county and terminal market prices.

The **terminal adjustment** (TA) is a value assigned by USDA employees and is used to minimize marketing assistance loan benefit differences between state and county boundaries and to reflect current market relationships. Other issues reflecting localized supply and demand factors may also affect the amount of *that* terminal adjustment.

The PCP Formula – Using the abbreviations offered for each component above, the formula is simply: TP +/- CD +/-TA = PCP. PCP calculations that feature two terminal prices use the higher-of-the-two-adjusted-prices (see *Illustration 5* below).

Implementing the PCP system is indeed complex. When terminal markets and county prices vary significantly because of differing supply and demand factors, the resulting impact can be a variance in PCPs and marketing assistance loan benefits between neighboring counties.

Corn is the dominant commodity covered by PCPs. In *Illustration* 5, two of the 10 terminal markets in the United States are used to calculate the PCP for a hypothetical producer in Christian County, Illinois in the following illustration:

Illustration 5

PCP Calculation Example		
Christian County, Illinois - Corn		
Terminal	**GLF** (Gulf Coast)	**TKO** (Decatur, IL)
Terminal Price	$2.41 per bushel	$2.08 per bushel
County Differential	- 0.46 per bushel	- 0.17 per bushel
Terminal Adjustment	- 0.43 per bushel	- 0.25 per bushel
	$1.52 per bushel	$1.66 per bushel
Posted County Price		**$1.66 (PCP)**

The PCP is set at the higher of the two adjusted terminal market prices. The concept underlying this higher-of-the-two-adjusted-prices approach is that the higher of the two terminal prices will be reflective of the price that producers receive for their commodity.

Specialized commodities, such as chickpeas and lentils, have fewer terminal markets. USDA uses only one terminal market when calculating the PCP for those commodities. The two PCP calculation examples on the next page are for different commodities; hard red winter wheat in Tripp County, South Dakota (*Illustration 6*), and grain sorghum in Cloud County, Kansas (*Illustration 7*):

Illustration 6

PCP Calculation Example		
Tripp County, South Dakota – Hard Red Winter Wheat		
Terminal	**PNW** (Pacific Northwest)	**MIN** (Minnesota)
Terminal Price	$4.56 per bushel	$4.38 per bushel
County Differential	- 1.07 per bushel	- 0.72 per bushel
Terminal Adjustment	- 0.32 per bushel	- 0.37 per bushel
	$3.17 per bushel	$3.29 per bushel
Posted County Price		**$3.29 (PCP)**

Illustration 7

PCP Calculation Example		
Cloud County, Kansas – Grain Sorghum		
Terminal	**AMA** (Amarillo, TX)	**GLF** (Gulf Coast)
Terminal Price	$3.13 per hundredweight	$4.17 per hundredweight
County Differential	- 0.81 per hundredweight	- 1.04 per hundredweight
Terminal Adjustment	+0.03 per hundredweight	- 0.65 per hundredweight
	$2.35 per hundredweight	$2.48 per hundredweight
Posted County Price		**$2.48 (PCP)**

Concerns over USDA's PCP system occur when program benefits differ widely in adjacent or neighboring counties, or when PCPs exceed cash market prices and when the local cash price plus LDP is below the loan rate.

Counties that are adjacent to those in different terminal markets, or counties where the two terminal markets used to calculate their PCPs are different, are more likely to reflect discernable differences. However, differences are not limited to border issues. *Illustration 8* on the following page demonstrates how within one county there is considerable variation in local cash prices.

Illustration 8

Mower County, Minnesota		
November 30, 2005		
Location – Cash	**Corn**	**Soybeans**
Grand Meadow	$1.38	$5.02
Sargeant	$1.35	$5.06
Dexter	$1.40	$4.99
LeRoy – Coop	$1.38	$5.04
LeRoy – Koch	$1.29	$4.95
PCP	**$1.43**	**$5.11**

The cash market for corn in Mower County varied by $0.11 on November 30. In the town of LeRoy, a village of 900 people 35 miles south of Rochester, Minn., there was a price difference of $0.09 between the two elevators that day. The same was true for soybeans.

Price quotes from different elevators within a specific county commonly vary for several reasons. Elevator facilities with truck, barge, and rail capabilities generally offer higher bids for commodities than those with limited services, choosing to move commodities using the least expensive option. With respect to rail services, companies with unit train (100+ cars) capabilities are generally in a position to offer a higher cash price due to volume discounts. Another reason that a particular location may quote higher or lower prices than other area elevators is based on their current demand for the commodity. For example, a company which has satisfied all delivery contracts is not compelled to offer high prices. Conversely, a company that is short in covering upcoming delivery obligations may be pressed to offer higher cash prices than other area elevators.

III. The Underlying Issues of the Posted County Prices System

Loan Deficiency Payments and Non-recourse Marketing Assistance Loans – Utilizing the loan provision is the only way for the producer to guarantee receipt of the loan rate for the applicable crop. USDA's CCC makes available non-recourse marketing assistance loans for certain commodities. The national loan rate for each commodity is set by statute. Loan rates for each county are determined once per year and all county loan rates for a particular commodity must balance back to the statutory national rate.

Once a loan rate is set for a year, it does not change. Loan rates are updated each year to reflect PCPs, production, and adjustments to differentials. There are many potential reasons for adjusting these differentials, including: (1) actual cash prices; (2) changes in production levels; (3) changes in marketing patterns such as the emergence of the ethanol industry; and (4) changes in transportation costs.

Marketing assistance loans provide interim financing to producers at harvest time to help meet cash flow needs without that producer being required to sell crops when market prices are typically at harvest-time lows.

Allowing producers to store newly harvested commodities enables them to market their commodities in a more orderly manner throughout the year.

Marketing assistance loans for covered commodities are *non-recourse* because the commodity is pledged as loan collateral and producers have the option of either delivering the pledged collateral to CCC as full satisfaction of the loan obligation when the loan matures or settling up in cash. Marketing loan repayment provisions specify, under certain circumstances, that producers may repay loans at less than principal plus accrued interest and other charges.

Alternatively, LDP provisions specify that, in lieu of obtaining a loan, producers may be eligible for an LDP.

Marketing assistance loan repayment and LDP provisions are intended to accomplish five objectives: (1) minimize potential loan forfeitures; (2) minimize accumulation of CCC-owned stocks; (3) minimize costs incurred by the government in storing the commodity; (4) allow the commodity to be marketed freely and competitively; and (5) minimize discrepancies in marketing loan benefits across state and county boundaries. Accumulating CCC-owned stocks can result in significant storage costs to taxpayers.

The challenge in setting PCPs is establishing PCPs reflective of local cash prices while minimizing the resulting discrepancies in marketing loan benefits. If PCPs in each county are reflective of local cash prices, differences in marketing loan benefits may naturally widen between state and county boundaries, contrary to statutory provisions. Conversely, if PCPs are established to ensure that differences in marketing loan benefits are held to a minimum, PCPs will not reflect local cash prices. When PCPs are adjusted to accurately reflect local cash prices, but the adjustments are limited geographically, then marketing loan benefit rift lines occur. Producers have been known to chase the higher benefit with the unintended consequence of drawing commodities to an area that, based on market conditions, does not need or want the excess commodity. *Illustration 9* shows the average gain per bushel of 2005-crop corn through the end of November. LDPs and marketing assistance loan gains through the end of November amounted to $3.1 billion on 7.0 billion bushels of corn, or $0.45 per bushel.

Illustration 9

2005 Crop Corn (as of November 30, 2005)		
Benefit	Quantity	Amount
LDPs	**6.79 billion**	**$3.035 billion**
Marketing Loan Gains	**0.23 billion**	**$0.105 billion**
TOTAL	**7.02 billion**	**$3.140 billion**
Average Gain = $0.45 per bushel		

The emphasis on the statutory requirement to minimize marketing assistance loan benefits across state and county boundaries has created equal benefits within specific geopolitical boundaries such as within a state. With a dynamic market place overlaying these static values, inaccuracies in the PCPs occur. An example of this was the differences in cash prices between western and eastern Iowa this last fall. Eastern Iowa suffered from drought conditions and then the impacts along the river of Hurricane Katrina causing lower cash prices. Western Iowa prices were not impacted in the same manner. Under the current PCP system all producers in Iowa received equal loan and LDP benefits on any given day.

Loan Rates – Another challenge occurs from using PCPs to determine county loan rates for subsequent crop years. Loan rates are established for each commodity and county on an annual basis and, conversely, market prices fluctuate on a daily basis to reflect local market conditions. Adjustments to lower PCPs in order to increase marketing loan benefits will result in lowering the county's loan rate in subsequent crop years. It is important to remember that an adjustment to a loan rate is a zero-sum game as county rates must balance back to the national level as set in the law.

As stated previously, the LDP plus the cash market price may not equal the loan rate. The 2002 Act does not guarantee this.

The 2002 Act provides that marketing assistance loans may be repaid at the lesser of the commodity loan rate plus interest, or at a rate determined by the Secretary of Agriculture that will minimize potential loan forfeitures and government accumulation of stocks and storage costs. The provision further requires the repayment rate to allow the commodity produced in the United States to be marketed freely and competitively, both domestically and internationally, and minimize discrepancies in marketing loan benefits across state boundaries and across county boundaries.

Unique Challenges in 2005 – Unlike previous years, PCPs have been affected by four key situations in 2005: (1) some of the typical advantages of barge rates over rail eroded late last summer because of lower water levels in the Upper Mississippi River system caused by drought in the Corn Belt states; (2) in the Mississippi and Texas Gulf regions, the "one-two punch" of Hurricane Katrina followed by Rita affected both rail and waterway transportation negatively; (3) energy and fertilizer prices soared in the past year along with the prices of crude oil and natural gas; and (4) significantly higher 2005-crop yields, coupled with carryovers from record 2004-crops, contributed to lower export demands.

IV. <u>Components of the Plan to Improve the PCP System</u>

The PCP system has been in place for many years and has undergone several in-depth reviews. Every harvest season, FSA receives calls and correspondence regarding the accuracy of the PCPs or the discrepancies in marketing loan benefits across state and county boundaries. FSA continues to look for improvements or new methodologies to use in setting the repayment rate for marketing assistance loans. FSA has initiated a review of the current policies and processes that compose the PCP system. This review will examine the basic assumptions regarding equal marketing assistance loan benefits and LDPs within a specific geographic or geopolitical area and the commonly held belief that the LDP plus the local cash price should equal the county loan rate. Further, emerging market dynamics like ethanol, fuel costs, and rail and barge capacity must be re-examined. All aspects of price discovery, including collection and reporting processes, will be studied. FSA intends to complete this review before the start of the 2006 marketing year. Ethanol is one impact worthy of further exploration.

Ethanol – The market impact of ethanol production on corn PCPs has become more apparent each year. FSA initiated price discovery efforts with ethanol producers in the 2004 crop year and has worked with industry experts to gain knowledge of the ethanol industry, pricing mechanisms, and contracting structures. In both 2004 and 2005, as part of the county loan rate review, county differentials were adjusted to reflect ethanol plant locations and market influences. FSA continues to study this strong emerging market force and to determine the optimal method to reflect its impact on the PCPs either through new terminal markets or additional differential adjustments.

Conclusions

There are many details and factors that influence 88,000 PCPs every day. We strive to keep our focus on the process, because the process helps us achieve a stable and consistent national system. Each day, the Kansas City Commodity Office (KCCO) obtains cash market prices from numerous terminal markets. Employees gather information on commodities such as corn, wheat, barley, oats, grain sorghum and soybeans. They use closing spot cash prices to determine the CCC terminal market prices that will be effective the next business day, which in effect, puts the PCPs one market day behind cash prices.

PCPs for each county (approximately 3,000) and for each commodity are determined daily. The process starts with terminal market prices, which are averages obtained directly from the industry. KCCO adjusts terminal market prices to create PCPs by applying county differentials that represent market influences, freight charges and other factors in order to reasonably simulate local conditions and accomplish the objectives established in the statute. Then KCCO considers price data from other market sources, such as AMS, DTN, and commodity exchanges, as well as other reliable information in the marketplace. Those factors figure into the adjustments made for each county.

KCCO completes the same process for other oilseeds and pulse crops with PCPs subject to change on a weekly basis. Employees also monitor relationships between PCPs and cash prices on a daily basis through industry surveys at more than 500 locations.

Despite the rigors set up for constant marketplace surveillance, it must be emphasized that the system is national in scope and therefore, vulnerable to local conditions. When PCPs do not accurately reflect local cash prices, USDA hears from producers. KCCO then searches for additional data from a variety of sources to verify whether these concerns are valid. If it appears that they are, USDA makes temporary adjustments that are determined to be appropriate with the objective of obtaining a PCP that better reflects the real cash market, and minimizes LDP spreads across state and county boundaries.

To accomplish the second objective – minimize LDP spreads – KCCO makes terminal market adjustments even though PCPs may already represent cash prices. A case in point occurred in central Illinois last year, a record setting year for corn and soybean production. USDA adjusted the TKO (Track Origin, Decatur, Illinois) terminal market during the week of September 20 to modify PCPs to more accurately reflect cash prices. To minimize the resulting discrepancies across state and county boundaries, KCCO also made adjustments to the dominant terminal market in Iowa and surrounding states. Without these adjustments, there would have been an eight-cent ($0.08) LDP difference between Illinois and Iowa.

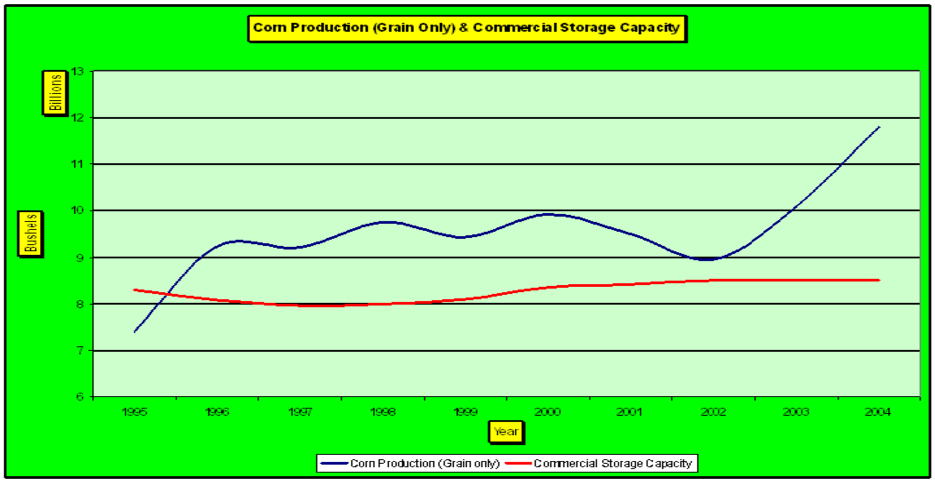
The net result of these adjustments was that PCPs in the surrounding states were substantially lower than cash market prices. It caused concern among state offices, producers and elevators. Calls received indicated that PCPs were *under* local cash prices ranging from nine cents ($0.09) to 45 cents ($0.45). However, LDP rates remained fairly consistent across state and county boundaries.

When PCPs fall out of line with cash prices in a county or region and it appears that the discrepancy may last, KCCO makes permanent adjustments to differentials for applicable commodities and counties.

Setting PCPs for the 2004 and 2005 crops has been challenging. Still, the overall program is meeting the mission prescribed by Congress. It minimizes loan forfeitures, minimizes the accumulation of stocks by the government, minimizes the government's cost for storing commodities, allows the commodity to be marketed freely and competitively, and minimizes discrepancies in marketing loan benefits across state and county boundaries.

If you look at our final illustration, you will see another potential challenge for the PCP system. The figure shows the rapid growth in corn production and the lack of growth in storage capacity since 2002. As storage capacity becomes increasingly tight in some areas relative to others, local market prices may deviate substantially across regions. We will be monitoring this development along with all the others to make sure that we continue to meet the objectives laid out in the legislation.

Illustration 10



At USDA, we believe we are meeting the legislative objectives of the marketing assistance loan program. Are our efforts without flaws? No. But the flaws usually surface when outside influences affect farming, such as natural disasters and high energy prices. The two most recent extraordinarily large crops have had a significant impact on administering the PCP system. We are aware of these risks and know how to make quick and successful adjustments to keep the program on task.